1976

Real Estate Tax Shelters: How to Tell a Good Deal from a Bad Deal

Marvin Kelner

REAL ESTATE TAX SHELTERS: HOW TO TELL A GOOD DEAL FROM A BAD DEAL†

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ALTHOUGH I HAVE PRACTICED LAW for many years, I believe it important to state at the onset that the views I have expressed in this article are those of a real estate "tax shelter" syndicator and deal primarily with the business aspects of these transactions. I have intentionally not discussed many of the substantive tax issues related to limited partnerships and tax shelters; many recent articles have done so in great depth.[1] It is assumed, however, that the reader generally understands the basic tax and legal consequences of an equity investment in a limited partnership.

Most of my experience in dealing with real estate tax shelters during the last five years has been derived from personal participation in the syndication[2] of section 236[3] and similar kinds of federally subsidized housing projects. Accordingly, some of my observations would not be

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† These remarks were delivered by Mr. Kelner in a real estate transactions seminar conducted by the Cleveland State University College of Law in April 1975, as part of its continuing legal education program.

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[1] *See, e.g.*, Bazos, *The Limited Partnership as a Vehicle for Syndicated Real Estate Investment: Selected Tax Considerations*, 1973 WIS. L. REV. 1124; Geller, *Depreciation on Real Estate and its Recapture: Resolving Problems Raised by the 1969 Act*, 29 N.Y.U. INST. ON FED. TAX. 1033 (1971); Glasser, *Gimme Shelter: Reform of Real Estate Tax Shelters*, 7 U. OF MICH. J.L.R. 267 (1974); Ritter & Sunley, *Real Estate and Tax Reform: An Analysis and Evaluation of the Real Estate Provisions of the Tax Reform Act of 1969*, 30 MD. L. REV. 5 (1970). For an excellent discussion of tax shelters, including real estate, see the JOINT COMM. ON INT. REV. TAX. (PREPARED FOR THE USE OF THE COMM. ON WAYS & MEANS), OVERVIEW OF TAX SHELTERS, 94TH CONG., 1ST SESS. (Comm. Print 1975). For an excellent review of a particular tax shelter deal, see 1 S. SURREY & W. WARREN, FEDERAL INCOME TAXATION 391-493 (1972 ed.).

[2] "In general, a syndicate is any joint venture, a temporary association of parties for the financing and execution of some specific business project." F. GARCIA, MUNN'S ENCYCLOPEDIA OF BANKING AND FINANCING 719 (6th ed. rev. 1962). Tax shelter syndications usually are in the form of a limited partnership, because that form, at present, offers substantial tax planning benefits while affording limited liability to the limited partners. For a concise analysis of the limited partnership's suitability for tax shelter purposes along with a discussion of current efforts by the Internal Revenue Service to place constraints on such use see Weidner, *Realty Shelter Partnerships in a Nutshell*, 8 IND. L. REV. 899 (1975). See also the definition of a partnership in Treas. Reg. § 1.761-1 (1972).

[3] National Housing Act, 12 U.S.C. § 236 (1968). The section 236 program provides subsidies by the FHA to various groups such as builders selling to non-profit groups at a fixed profit, investor/sponsors selling to tenant cooperatives at a fixed profit, and limited-distribution sponsors, with a limited cumulative return on the initially endorsed mortgage amount, who intend to build multifamily housing for moderate and low income families. The program is usually financed through FHA insured 40-year mortgages provided by FNMA or GNMA at rates established by FHA (which may vary from time to time depending on the market) and then subsidized so that the mortgagor (partnership) pays an effective interest rate of only one percent. P. DAVID, URBAN LAND DEVELOPMENT 272 (1970).

appropriate when considering an investment in a conventionally financed real estate project except when so stated.

I would also emphasize that the purpose of these comments is to impart basic knowledge to the legal or financial advisor who is asked to render advice to his (or her) client (who is assumed to be in at least the 50 percent marginal income tax bracket) on whether to invest in a particular real estate tax shelter syndication. Hopefully, this article will enable such an advisor to give an informed opinion regarding the investment without holding himself out as an expert in real estate tax shelters. The following are my views with respect to important standards against which one can test the desirability (and wisdom) of a particular real estate syndication.

I. Basic Factors in Real Estate Syndication Analysis

A. *The Offering Circular*

The "face" of a real estate syndication invariably takes the form of an offering circular.[4] This document is the prime "sales tool" for syndications and is likely to be the only document available to the advisor upon which to base his opinion. The offering circular is constantly growing in size and complexity, today averaging approximately fifty pages of solid legal jargon, aside from the basic partnership agreement[5] and financial projections.[6] These documents are difficult reading and usually impossible for a layman (as well as many attorneys and accountants) to understand unless they are dealt with on a regular basis. I have, therefore,

[4] An offering circular today may have other names, *e.g.*, private placement memorandum, confidential memorandum, or prospectus. "What's in a name? That which we call a rose by any other name would smell as sweet." W. Shakespeare, Romeo & Juliet, Act II, Scene 2.

The tax shelter deal which offers for sale interests (units) in a limited partnership has been determined to be a security requiring registration of the prospectus with the Securities & Exchange Commission, under the Securities Act of 1933, unless counsel can find an applicable exemption. 15 U.S.C. §§ 77a-77aa (1971). Virtually every state which regulates the sale of securities has also defined the term "securities" to include limited partnership units. For a summary of securities law, exemptions, and liabilities, see R. Haft, Tax Sheltered Investments, Taxation-Securities §§ 2.02-.04 (1973). For disclosure guidelines, see Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq.* (1971). See also R. Haft, *supra*, at §§ 3.01-.17. For a sample circular, see R. Haft, *supra*, at App. G. See also G. Silbert, Tax Sheltered Investments 262-85 (1973). See also S. Surrey & W. Warren, *supra* note 1.

[5] Partnership agreements should be written as counseling documents to alert the client to responsibilities and liabilities. Weidner, *supra* note 2, at 899. For sample partnership agreements, see G. Silbert, *supra* note 4, at 67-69 (1973); 2 J. Barrett & E. Seago, Partners and Partnerships, App. 4, at 533 (1956).

[6] For a suggested form, see Excerpts from SEC's Real Estate Advisory Comm. Rep. in Haft, *supra* note 4, at App. B. For California and the Midwest Securities Commissioners Ass'n proposals on projections, see Haft, *supra* note 4, at App. D. The Real Estate Advisory Committee has expressed concern that prospectuses have become devices for protecting promoters, rather than means of informing potential investors. Why else would they be so redundant? The Committee recommended that the SEC "promulgate standard assumptions to serve as a basis for numerical disclosure of the potential economic results" of participation in tax shelters, suggesting such standards as useful lives, items to be capitalized and deducted, and consequences of dispositions. Dickey, *What Lies Ahead for Real Estate Regulation*, 3 Real Estate Rev. 13 (1973). Real Estate Guide 60 was recently adopted by the SEC. CCH Fed. Sec. L. Rep.¶ 80, 405 (1976).

focused my comments in this article on those points which are, or should be, disclosed by the offering circular.

B. *Tax Shelters versus Yield Deals*

A "tax shelter" deal (not a tax shelter*ed* deal) is one which generates losses to be used by the typical high income bracket investor to offset other income on his tax return. A "tax shelter" deal is to be contrasted with a "yield deal" which is an investment primarily for the purpose of receiving cash income on the investment. Thus, if the investment in a deal is $10,000 and the purpose is to receive a yield of ten percent, or $1,000, as an annual cash flow distribution on the investment, that is a yield deal — not a tax shelter deal.

The distinction between tax shelter and yield deals is rather clear, probably more so to laymen than professionals. Rarely in the last five years has a client of mine expected to receive significant cash flow on a tax shelter deal; instead, they sought to incur losses to offset other income. Such a purpose involves the use of the term "tax shelter" in a precise sense.[7] A municipal bond, for example, is not a tax shelter device. It provides tax free or tax sheltered income but it is not a tax shelter because it does not "shelter" other income from the imposition of income taxes.

Tax shelter means that the investor can use the tax savings "fund" generated by the tax shelter to make other economic investments which will produce a meaningful return. This return may be produced in a variety of ways: It may be produced by reinvestment of the tax savings in savings accounts, certificates of deposit, and other relatively secure investments. It may also be used to make investments in common stocks, thereby enabling the investor to (hopefully) realize long-term appreciation from an increase in value of the stocks. On the other hand, the investor may invest the tax savings in high paying, rather high risk, corporate bonds which may produce a cash yield to him of ten or eleven percent in today's market. The point is this: If one confuses the motivation for making the tax shelter investment with the use to which the tax savings generated by the tax shelter investment should be put, one does himself and his client a disservice. The sole purpose of a tax shelter, in my opinion, should be to provide funds to the investor with which to make an investment that will accomplish an economic gain. Conversely, the purpose should *not* be to provide the investor with an opportunity to realize a significant economic gain from the tax shelter investment itself. In my experience, when the investor attempts to combine both objectives, the results are usually unfavorable for both. It is my belief that an investor, and his representative, should make every effort to distinguish between a tax shelter investment, for which the sole motivation should be to provide the investor with tax shelter dollars, *i.e.*, an investment

[7] In the past, the term "tax shelter" has usually been broadly defined to include any kind of tax-favored investment. *See* Whitted, *Some Rules for the Evaluation of Tax Shelters*, 1976 TAXES 27. This practice will probably continue until the tax shelter-yield deal distinction becomes more generally recognized.

fund, and an economic investment for which the purpose is to return to the investor a fair economic return on his investment.

In stating this, I immediately have visions of all the Internal Revenue agents in the country converging on my office outbidding each other for my list of investors. Allow me, therefore, to reemphasize that when I refer to tax shelter deals, I am addressing myself to low income housing projects where cash flow returns are limited by law and long-term appreciation possibilities may be limited by the practical considerations inherent in such properties. Other tax shelter deals, *e.g.*, movies, oil, and citrus groves, may have great potential economic returns but also have high risks one would expect to assume in order to achieve such returns.

If a tax shelter is the primary objective of the investor, the risks of the deal should be as small as possible when compared with the risk one would assume if yield were the primary objective. *The greatest risk in a tax shelter investment should be the likelihood of the investor remaining in a high tax bracket during the period the investment is projected to generate tax losses.* Absolute certainty of sufficient income is not required — only a realistic probability of such income recurring is necessary.

C. *Risk of Foreclosure*

If the client's investment objective is a real estate tax shelter, the first consideration, and by far the most important, is the risk of foreclosure.[8] If the risk of foreclosure is substantial, or even a likely possibility, the advisor must not allow the investor, whatever his income tax bracket, to invest in the deal even if the return is exceptionally great in terms of tax shelter. Although one cannot definitely know whether the property will be foreclosed upon, the advisor should assure himself that the deal contains important safeguards against foreclosure; some of these safeguards are discussed later in this article.

The risk of foreclosure is an equally important consideration whether one chooses to invest in a yield or a tax shelter deal. Obviously, the greater the rewards one seeks, the greater the risks one must take in order to achieve them. Consequently, one might "bend" a little with regard to risk-taking in the case of a nontax shelter motivated investment in order to obtain the high yield that is being proffered. The advisor, however, should not allow his client to make an investment in what he considers to be a very high risk deal — unless the investor specifically states that he wants to take the gamble.

D. *Cash Flow*

Net cash flow on a tax shelter investment should not be of significant interest except with regard to the "hobby loss" provisions of the Internal Revenue Code.[9] It is helpful, however, if the project will produce a net

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[8] Foreclosure of the mortgage on the underlying project is probably the greatest risk in any real estate tax shelter, the consequences of which are explored in depth in Ginsberg, *The Leaky Tax Shelter*, 1975 TAXES 719. For the more common reasons for foreclosure in a section 236 project see Kaster, *Subsidized Housing: Facts Versus Tax Projections*, 26 TAX LAW. 125, 133-37 (1972).

[9] INT. REV. CODE OF 1954, § 183.

cash flow that will be sufficient to pay the capital gains tax inevitably due upon disposition of the investment. Other than that, cash flow is relatively insignificant. Of course, the greater the cash flow produced by the investment, the less value it will have as a tax shelter since cash flow will always have the effect of reducing the amount of tax losses otherwise available to the investor.

If the cash flow originally projected is not generated, usually only one-half of the nonrealized cash flow will be lost to the investor because the tax losses should be greater by an equal amount. Thus, if the investor is in the 50 percent tax bracket, one-half of the cash flow projections not actually realized should be available to the investor through additional tax savings. Remember, it is generally not necessary to assume high risks in order to produce significant after-tax cash benefits; it is absolutely necessary to take high risks in order to produce high cash flow.[10]

In a typical yield deal, the net cash flow is of very great significance. The cash yield on a nontax motivated investment should be at least nine or ten percent and preferably higher. Although everyone wants the greatest amount of cash flow on an investment so that an economic return is secured, it is very important to achieve a return which is in balance with the amount of risk taken. Over the last few years, more and more deals have been structured to give the appearance of a good return without taking into consideration the increased risk to the investor.

The risk of foreclosure is not lessened because investors have a priority with regard to cash flow. The investor still loses his money if the project does not succeed. Consequently, in a conventionally financed real estate project, such as an apartment house or an office building, the cash flow "priority" to the investor, who is usually putting up all of the equity money, should be at least ten percent in order to induce him to make the investment. The effect of a lower preference return to the investor-limited partner is that the general partners will be too well paid for an investment opportunity in which they have little or no investment. If the project is very successful, the developer or other general partner should share in the rewards of the deal, even on an equal basis with the limited partners. Yet these rewards should not be forthcoming to the developer or other general partner until the project has distributed to the investor-limited partners a return that is commensurate with the risk to which their investments were exposed.[11]

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[10] High risk is not necessarily related to high tax loss (*i.e.*, a large write-off), whereas high risk is necessarily related to high cash flow (in unseasoned real estate). V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 63-66 (1972). *But see* Whitted, *Some Rules for the Evaluation of Tax Shelters*, 1976 TAXES 31, 33 for a discussion of a risk-tax loss ratio which notes the importance of avoiding the appearance of a sham to avoid taxes.

[11] It is unfortunate that many conventionally financed real estate deals are syndicated as tax shelters when they contain all of the risks attendant upon high cash flow projects. Specifically, many offering circulars contain the "magic" language to the effect that "investment in the partnership is not appropriate to persons whose marginal tax bracket is less than 50 percent." I do not believe that this language, and its obvious inference that the deal is a "tax shelter," is appropriate when the deal itself is a high risk in terms of potential foreclosure and when generation of the cash flow projected is dependent upon the rental of suites at competitive rates of rent. Moreover, although many of these syndications contain priorities in favor of the limited partners, these priorities are a two-edge sword in

The "quick potential" of cash flow is important in a yield deal. It is of even greater importance that potential return be higher than historical return. In other words, if an investment is made in an apartment house or an office building to be constructed, the priority return to the investor-limited partners should be significantly higher than the return from a project which has historical support for the yield that has been forecasted for the investor.

Another important consideration in determining the percentage of cash flow appropriate for the risks of a particular investment is whether the cash flow is tax-free to the investor and, if so, for how long a period of time. By this, I do not mean that the investment produces tax shelter to offset other income of the investor. Rather, the income from the project itself might not be taxable to the investor because the depreciation generated by the property significantly offsets the net cash flow distributions to be made to the investor-limited partners. A nine or ten year tax-free return on investment on an apartment house project is "worth" more than a similar rate of return on a warehouse project (part or all of which may be taxable to the investor beginning with the first or second year) because of the long lives assigned to warehouse projects by the Internal Revenue Service.[12]

In summary, it is not necessary that a successful tax shelter investment generate a cash flow; it simply must not be foreclosed. On the other hand, a deal in which an investment is made primarily for economic yield must have a large cash flow in order to accomplish the objectives of the investor. Otherwise the investor will have failed in his venture, even though the project has not been foreclosed. If both tax shelter and yield are the objectives of the investor (although it was earlier stressed that they should not be), and the projected yield is not achieved,

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that they not only grant the priority to the limited partner, but also are a "cap" on the cash flow distributable to the limited partner. This arises because the general partners usually receive the cash flow generated by the project in excess of the priority amount until they are "even" with the limited partners. Thus, the investor is exposed to all of the risks noted above, but the "cream" of the deal, if highly successful, belongs to the developer — general partner. These deals are neither fish nor fowl and the tax shelter which they do generate may derive from real losses to the investor and not "paper" losses.

I do not mean to imply that all such structured deals are bad deals or inherently unfair to the investor. My point is simply that they should not be marketed to investors as "tax shelters" when, in fact, the risks to which the investment is subject suggest that such deals are "yield deals." Thus, in my opinion, the cash flow priority to the limited partners should not be less than ten percent and the language regarding tax brackets should be omitted; these deals should stand on their own.

[12] The partners are interested in the most rapid depreciation allowable. Therefore, it would be well for them to be aware of the Internal Revenue Code's preference for residential to commercial buildings. The highest rates allowable are the following: residential rental (new) — 200 percent declining balance; residential rental (used) — 125 percent declining balance; commercial (new) — 150 percent declining balance; commercial (used) — straight-line method. INT. REV. CODE OF 1954, §§ 167(j)(1)(B), (j)(2), (j)(4), (j)(5).

But just as important to the investors is the determination of useful life. The Internal Revenue Service has set useful life guidelines of 40 years for apartments and 60 years for warehouses. Thus, in determining the depreciation for a year, the investor must multiply his basis not only by the rate figures but also by the reciprocal of the building's useful life. *See* Rev. Proc. 62-21, 1962-2 CUM. BULL. 420 and, more importantly, Rev. Proc. 72-10, 1972-1 CUM. BULL. 721, containing the ADR classification for useful life of many kinds of property.

it is no justification to say that the investor has, in any event, achieved the benefits of the tax shelter. If the investor had wanted to achieve only tax benefits, he probably would have been able to make a much better investment which would have yielded significantly greater tax benefits for the same amount of money without the increased risks attendant to that particular deal. Thus, a yield deal which has failed to produce the income objectives of the investor does not usually produce a good tax shelter when evaluated by the number of dollars invested in the deal.

E. *Long-Term Appreciation*

A frequently stated objective of an investor in a tax shelter is to achieve substantial appreciation of the property during the period the investment is intended to be held. When analyzing a tax shelter, if comparing a conventionally financed apartment house (a "conventional project") with a subsidized housing project (a "subsidized project"), one would properly conclude that long-term appreciation is more likely in the conventional project. Nevertheless, the prospect of long-term appreciation is an irrelevant consideration in determining whether to invest in a particular tax shelter deal. One must always bear in mind that the purpose of the investor is to provide himself with tax shelter. Tax shelter does not mean cash flow nor does it mean long-term appreciation. It should be reemphasized that my remarks are in reference to low-income housing projects with cash flow returns limited by law and long-term appreciation possibilities limited by the practical considerations inherent in such projects.

For example, consider an FHA section 236 project to be rented primarily to elderly persons. It is impractical to expect that such projects will experience significant long-term appreciation. The tenants in such projects pay a rent for their suites that is approximately 50 to 60 percent (or less in some projects) of the fair rental value they would pay for the same suite in the same neighborhood. Such low rent is possible only when a section 236 or other federal subsidy is available — often a significant real estate tax abatement is provided by the local community or the state in which the property is located. It is simply not realistic to assume that twenty years from commencement of occupancy, one will be able to refinance the property with a conventional lending source which would precipitate the loss of the rent subsidy and the tax abatement. Such refinancing would probably result in a 50 percent increase in rent to the tenants in the building and consequently, the eviction of people barely ambulatory and financially destitute.

If, however, the elderly project is generating a cash flow, that stream of income, which is probably tax-free even to a "second user," would be saleable at some price. Such income could probably not be capitalized at more than ten to twelve percent and, therefore, a selling price on such basis (cash above the existing mortgage balance) would be relatively nominal when compared to the reproduction cost of the building.

It is not inconceivable, however, that a well-built, well-located federally subsidized *family* project, attractive when first opened and carefully maintained, would have a significant value 20 years hence. I have syndicated a number of such projects which I believe will constitute fine, saleable projects at that time. Nevertheless, I never assign a residual value of more than one dollar to the property when presenting the Return on Investment Schedule (Schedule C) to an investor, and I do not encourage investors to believe otherwise.

F. *Rules of Thumb*

There are a number of technical standards against which one can measure a proposed investment in a real estate tax shelter. I use the term "standards" in the sense of "rules of thumb"; they are not listed in any particular order of importance.

1. *Loss/Investment Ratio*

An important consideration is the ratio of deductible tax losses that can be offset against other taxable income to the dollars invested. For example, if one invests $10,000 in a deal, how much loss will be made available to offset other income on the tax return? Obviously, if $10,000 is invested and $20,000 of losses in the year of investment is available to offset other income, that is a rather good ratio of losses to investments.[13] In the case of an investment paid for in four or five annual installments, this analysis must be made on the basis of the total losses available over the entire pay-in period.[14]

Let's look at Schedule B of the projections for 50 percent income bracket taxpayers. Note that in column (7) (headed "Investments"), the investment in 1975 was $8,650 (year one of the investment). Moving to column (2) for the same year, the tax loss was $17,759. In this instance, the investor was provided with a tax loss of approximately 2:1, a particularly good ratio of losses to dollars invested. Look at the next year, 1976. The investment was $9,230 and the projected loss was $18,271. In both years, the 50 percent bracket taxpayer had no out-of-pocket investment because 50 percent of the projected loss of $36,030 ($17,759 + $18,271) is $18,015, $135 more than the investment of $17,880. Thus, the tax savings covered the entire investment making it a very deep shelter for the investor in years one and two (and so on down the line as one reviews the numbers). Most tax shelter investments are paid in on an installment basis over a three, four, or five-year period and if the loss-investment ratio during the total investment period averages 1.5:1 or better, it is usually an advantageous deal, numberwise, for the investor.

2. *After-Tax Rate of Return*

Schedule C — 50, at the end of this article, is entitled "Return on In-

[13] A loss which is substantially in excess of the investment is sometimes referred to as a "deep shelter."

[14] Make the analysis on a year-by-year basis and on a cumulative basis over the period of investment.

vestment Schedule." The return on investment indicated therein is 28.12 percent, an exceedingly high rate of return and difficult, but possible, to achieve. It is analogous to the rate of return one would receive on an investment in a tax-free municipal bond. Moreover, a careful examination of the schedule indicates that the high rate of return is achieved after providing for payment of a capital gains tax upon the sale of the investment.

One could dwell for many pages on the various meanings of the numbers in this schedule. What is emphasized, however, is the *use* of the schedule rather than its intrinsic meaning. For example, if three deals are presented to the advisor for consideration and each has a return on investment schedule prepared in the same manner, it will obviously be easier to evaluate these deals in terms of bottom-line, after-tax economics by comparing the rates of return, rather than to examine separately the importance of any individual numerical standard. Note that the effect of a return on investment schedule is to distill all of the important numbers in the deal into a net "bottom-line" result expressed by the after-tax rate of return. The price paid by the investor to participate in the deal in relation to the amount of tax losses and cash flow, the period over which the investment is paid in, and the timing of the return to the investor of the actual tax savings and cash flow he may enjoy, are all taken into consideration in the computation of the rate of return disclosed by such schedule. Thus, a deal priced to the investor at 18 percent of the mortgage may produce a higher rate of return than a deal priced at 16 percent of the mortgage. This would occur if the lower-priced deal were to be paid for over two annual installments and the higher-priced deal in five installments over a 48 month period. The time value of money,[15] therefore, is very important in computing the rate of return shown by the schedule. This consideration, the "use" of money, is or should be the primary objective of every tax shelter and the most meaningful numerical measurement of the investment's value.

In summary, the primary use of a return on investment schedule should be to compare one deal with another. Its use should also enable an investment advisor to effectively measure the after-tax yields on particular deals. Finally, it should disclose the amount of tax dollars ultimately payable upon disposition of the property or limited partnership unit.

II. Tax Shelter Real Estate

A. *Apartments: Federally Financed versus Conventionally Financed*

Depreciation for qualified used residential rental property is restricted to either the straight-line method or the declining balance method, using a rate not exceeding 125 percent of the straight-line rate.[16] In

[15] A dollar to be paid in the future is worth less than a dollar payable today. For a further explanation of present value, including charts, see V. Brudney & M. Chirelstein, Corporate Finance 32-81 (1972).

[16] Int. Rev. Code of 1954, § 167(j)(5)(A), (B).

contrast, new residential rental property, the original use of which commences with the taxpayer, may be depreciated by 200 percent of the straight-line rate or the sum of the years-digits method.[17] Since the more advantageous "first user" depreciation is available only for newly constructed apartment houses, the following discussion will be confined to various types of new residential property.

There are two kinds of apartment house projects that can be considered tax shelters: federally financed and conventionally financed projects. Federal projects are of two basic types: subsidized and nonsubsidized, both of which are financed with forty-year mortgages provided by the Federal National Mortgage Association (FNMA) or the Government National Mortgage Association (GNMA).[18] Those multifamily housing projects referred to as subsidized are described in section 236[19] and section 221(d)(3)[20] of the Housing and Urban Development Act of 1968 and, more recently, by section 8 of the Housing and Community Development Act of 1974.[21] All of these projects provide housing for low and moderate income families who qualify on the basis of their annual incomes.[22] The government subsidy comes in the form of rent supplement payments made directly to the mortgagor (usually about 70 percent of the market rental value determined by FHA) in the section 221(d)(3) program. Section 236 projects are financed with FNMA or GNMA at an interest rate fixed by FHA, but FHA subsidizes all interest payments in excess of one percent.[23] The savings in debt service thus provided by the lower interest rate is passed on to the tenants in lower rentals (usually two-thirds of market rental value). These FHA-insured permanent mortgages impose no personal liability on the owner of the property.[24] Rents charged to tenants and cash flow distributed to the owner are controlled by FHA as are many other matters relating to the operation of the property.

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[17] INT. REV. CODE OF 1954, §§ 167(b)(2), (3), (j)(2)(A).

[18] FNMA was originally authorized by the National Housing Act. Under the Housing and Urban Development Act of 1968, 82 Stat. 476 (codified in scattered sections of 5, 12, 18, 20, 31, 38, 40, 42, 49 U.S.C.), the assets and liabilities of FNMA were transferred to a private corporation of the same name. Certain of its former responsibilities were assigned to a newly created corporation, GNMA, which is financed by the federal government. *See* H. HOAGLAND & L. STONE, REAL ESTATE FINANCE 534-51 (1973).

[19] 12 U.S.C. § 1715z-1 (Supp. IV, 1974), *amending* 12 U.S.C. § 1715z-1 (1970).

[20] 12 U.S.C. § 17151(d)(3) (Supp. IV, 1974), *amending* 12 U.S.C. § 17151(d)(3) (1970). The section 221(d)(3) mortgage insurance program is almost always combined with section 101 of the National Housing Act which provides for rent supplement payments to eligible tenants. The effect of these two programs is to enable qualified tenants to pay only approximately 30 percent of the fair rental value of the suite or 25 percent of their income, whichever is greater.

[21] 88 Stat. 633 (codified in scattered sections of 5, 12, 20, 31, 40, 42, 49 U.S.C.).

[22] The intent of Congress in enacting section 211(d)(3) and section 236 projects was to provide rental housing for families whose incomes were too high for public housing but too low for standard housing. 2 U.S.C. CONG. & ADMIN. NEWS 2894, 90TH CONG., 2D SESS., 1968. This housing is for low and moderate income persons; it should never be considered that such housing is low-cost.

[23] *See* P. DAVID, URBAN LAND DEVELOPMENT 272 (1970).

[24] *Id.* at 278; Halperin & Tucker, *Low Income Housing (FHA 236) Programs: One of Few Tax Shelter Opportunities Left*, 36 J. OF TAX. 2 (1972).

Typical of the nonsubsidized federally financed projects are section 207[25] and section 221(d)(4)[26] projects. Section 207 "luxury-type" apartment projects are designed to facilitate the production of housing at middle and upper-middle income levels. Section 221(d)(4) projects give priority in occupancy to middle income families displaced by urban renewal but, in fact, are not located in urban renewal areas and are rented to all applicants. Both are rented at fair market rental rates with mortgage interest payments at current interest rates. Although rents are controlled by FHA, cash distributions to owners are not so limited.

It is not my purpose here to elaborate on the different kinds of federally financed housing projects except to make this comment: Section 236, section 221(d)(3), and section 8 subsidized projects are usually much lower risk investments than either the federally financed nonsubsidized projects or conventionally financed housing. This is a result of the substantially lower rents charged tenants in these projects. Therefore, a well-managed project in an appropriate location is more likely to remain rented to capacity.[27]

As stated at some length above, because of the higher risks in a conventionally financed apartment project, the motivation for investing in them should be to secure a good monetary return on the investment. Notwithstanding such motivation, substantial (if not "deep") tax shelter will be afforded to the "first user" as an incident of ownership.[28] Consequently, the investor may not need to seek a tax shelter investment if the tax shelter is already being provided by an investment made for yield purposes.

The nonsubsidized section 221(d)(4) and 207 projects make excellent tax shelters except that the risks taken are at least as great as those taken with conventional apartment projects because rental is at market rates. I would point out, however, that these projects provide substantially greater tax benefits than conventionally financed housing projects. They are thus considered by many to be worthy of consideration as tax shelters even though the risks are substantially greater than those of subsidized housing projects.

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[25] 12 U.S.C. § 1713 (1970).

[26] 12 U.S.C. § 17151(d)(4) (Supp. IV, 1974), *amending* 12 U.S.C. § 17151(d)(4) (1970).

[27] A recently syndicated subsidized project in Tampa, Florida will demonstrate this point. Tampa, at the time of this syndication, had a vacancy factor of 13.5 percent in conventional projects. On the other hand, almost every subsidized project in the area had an average waiting list of approximately 20 to 25 percent of the total number of units available for rental in each such project. As the units in the project which I syndicated became available for occupancy in the summer of 1975, it became obvious that the units were being rented so quickly that the projections which had been made regarding the tax losses in 1975 and 1976 were likely to be lower by approximately 10 percent than would have been the case had the project filled up in accordance with the original rental schedule established for that project. In my opinion, upon completion of the rent-up of this project, there will probably be a waiting list of approximately 20 to 25 percent of the total number of units available for rental. This should be the case in every instance if the project is well conceived, well constructed, well located, and well managed. Obviously, the risk of foreclosure in this project is significantly less than it would have been if it were a conventional project.

[28] INT. REV. CODE OF 1954, §§ 167(j)(2)(A), (b)(2), (b)(3).

There are three reasons why such projects provide greater tax benefits. First, like practically all subsidized projects, the amount and character of the financing costs[29] of these projects are significantly greater than with conventional projects; consequently, the tax losses over the first several years are significantly larger. Second, the prices at which these projects are traditionally offered is such that the investors receive a great deal more leverage[30] than had they purchased an interest in a conventional project. The third factor relates to the 40-year term of mortgages insured under FHA programs, as opposed to conventional projects in which the mortgage term is only 25-30 years.

There are several specific tax benefits available only to subsidized federally financed apartment projects. First, the recapture of depreciation on property constructed or acquired by the investor before January 1, 1976, is completely eliminated after a holding period of ten years; other residential rental property is subject to a 16 2/3 years holding period.[31] Second, there may be a "rollover" of the realized gain when the proceeds from the approved sale[32] of a section 236 or 221(d)(3) project are reinvested in a similar project within a limited period of time.[33] Third, as previously mentioned, there are usually more "soft dollar" deductions[34] in the first several years of subsidized rather than conventional projects, thus creating more tax deductions per dollar of investment. These three factors, however, are not critical.

Aside from the lower risk, the most important reason why an FHA project is a better tax shelter than a conventionally financed project is the length of the mortgage term. In an FHA insured project (with or without subsidy), the length of the mortgage term is 40 years; in a conventionally financed project the mortgage term is generally between 25 and 30 years. This difference means that in the longer mortgaged

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[29] *E.g.*, construction financing fees, commitment fees to the permanent lender, and mortgage insurance premiums. *See, e.g.*, Kaster, *Subsidized Housing: Facts versus Tax Projections*, 26 Tax Law. 125, 129-30 (1972).

[30] Leverage here refers to the ratio of investment to loss. In a conventional project, the price to the investor is usually 25-35 percent of the mortgage whereas in those projects financed by FNMA and GNMA, the price to the investor is usually 15-20 percent of the mortgage. Thus, because depreciation is computed on the total cost, the deductions per dollar of investment (investment equity) are greater in a federally financed project (as well as the "soft costs" such as construction interest and financing fees).

[31] Int. Rev. Code of 1954, § 1250(a)(1)(c)(ii). After January 1, 1976, the required holding period will be the same as that for conventionally financed projects (*i.e.*, 16 2/3 years).

[32] Int. Rev. Code of 1954, § 1036(b)(2). An approved sale must be to the tenants or occupants or an organization formed for their benefit.

[33] "At the election of the taxpayer, gain from such approved disposition shall be recognized only to the extent that the net amount realized on such approved disposition exceeds the cost of such other qualified housing project." Int. Rev. Code of 1954, § 1039(a)(2). The basis of the newly acquired project is its cost reduced by the amount of the gain not recognized on the earlier disposition. Int. Rev. Code of 1954, § 1039(d). Section 1039 was added December 30, 1969 and since most projects syndicated to date would still be viable tax shelters, it is doubtful whether anyone has had reason to voluntarily transfer their investment under this provision.

[34] "Soft dollar" deductions are characterized as ordinary and necessary business expenses as opposed to capital expenditures and thus are currently deductible. *Compare* Int. Rev. Code of 1954, §§ 161, 162(a) *with id.*, § 263.

project, the tax shelter will not completely expire for a period of 18 to 20 years after investment; whereas the tax shelter with a 25 to 30 year mortgage will expire in eight to ten years.[35] This is of prime significance because in the case of a tax shelter investment, the most important single factor (in fact, the sole reason for making the investment in the first instance) is to have the use of the money over a long period of time.[36] The longer the period of time during which the investor can reinvest his tax savings, the more return he will show from that investment. It is not important that the loss in the nineteenth or twentieth year of an FHA insured project is, for example, only $100 in the case of an individual limited partnership unit; what *is* important is that there is no taxable profit.

B. *Commercial Real Estate*

Commercial real estate includes office buildings, warehouses, factories, shopping centers, and the like. These kinds of projects, in my opinion, should not be marketed as tax shelters even though they may provide tax shelter as an incident of investment. The amount of tax shelter provided to the investor, compared with the amount of dollars invested in the project, is such that it would take from eight to ten years (longer in many cases) to recover the investment *solely from the tax benefits*.[37] Consequently, they should not be considered as tax shelters except in one case; In rare circumstances, there may be an investor who has a substantial increase in income over a one or two year period in an amount greatly in excess of his average income. The deductions provided by a newly constructed commercial property over the first two years, derived primarily from construction interest and construction financing costs, will provide significant tax shelter during the years in which that particular investor requires the tax shelter. Additionally, it will provide a significantly lower amount of tax shelter in succeeding years when the requirement for such tax shelter is diminished. With this one exception, I would not recommend commercial real estate as a tax shelter investment.

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[35] In the operation of a real estate investment, the most significant cash paid expense which is not deductible is repayment of principal. The only deductible expense which does not involve an ultimate cash outlay is depreciation (hence, sometimes characterized as a "paper loss"). Therefore, as long as depreciation exceeds repayment of principal, deductions exceed cash outlay and a tax shelter exists. In a level payment mortgage, the length of time over which this desired relationship will exist increases as the length of the mortgage increases.

[36] Of course, the disadvantage of a 40 year mortgage in the case of a subsidized project is that at the time of disposition there is little amortization of principal of the mortgage which will have occurred over the first 20 years of the project. My calculations indicate that in the case of a 40 year, 7 percent mortgage, only 16.5 percent of the original mortgage amount has been amortized over the first 20 years whereas in a conventional project, approximately 50 to 60 percent of the original mortgage amount has been amortized. Principal amortization, however, should not be the primary objective of an investor who is seeking tax shelter.

[37] It must be remembered that depreciation for new nonresidential realty is limited to 150 percent declining balance. INT. REV. CODE OF 1954, § 167(j)(1)(B).

C. *State Housing Agency Deals*

State housing agency deals, in combination with a section 236 subsidy,[38] or section 8 rental assistance payments,[39] are often better tax shelters than straight FHA section 236 or section 8 deals because they usually have more financial controls built into the project and therefore afford more financial protection against mortgage foreclosures. Michigan State Housing and Development Authority[40] deals, for example, are usually the best because they have particularly unique protections structured into the financing to safeguard against foreclosure such as the Equity Escrow Fund and the Development Cost Escrow Fund.

On the other hand, most state housing agency deals offer slightly less tax benefits in the early years because a lesser amount of fees is paid to the state agency which would otherwise be amortized over the construction period.[41] This difference, however, is not terribly significant, and therefore, such projects usually command the same price as straight FHA section 236[42] deals.

III. Things to Look for and Lookout for in Tax Shelter Deals

A. *The General Partner*

The most important nontax consideration in a tax shelter investment is the general partner of the limited partnership. One must first consider his track record, that is, has he constructed and managed similar kinds of properties or is this his first attempt at a subsidized project.[43] Second, the net worth of the general partner is very important. Here I am not concerned with the guidelines set forth in Revenue Procedure 72-13;[44] in fact, I am offended if a corporate general partner has been

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[38] 12 U.S.C. § 1715z-1 (Supp. IV, 1974), *amending* 12 U.S.C. § 1715z-1 (1970).

[39] 12 U.S.C. § 1706 C (Supp. IV, 1974), *amending* 12 U.S.C. § 1706 C (1970).

[40] *See* Mich. Comp. Law § 125.1401 *et seq.* (1967).

[41] *See e.g.*, Rev. Rul. 75-172, 1975 Int. Rev. Bull. No. 19, at 17.

[42] 12 U.S.C. § 1715z-1 (Supp. IV, 1974), *amending* 12 U.S.C. § 1715z-1 (1970).

[43] Van Camp, *Living with Tax Shelters in California: A Discussion of the New California Real Estate Syndication Rules*, 7 U. San Fran. L. Rev. 403, 405 (1973).

[44] Rev. Proc. 72-13, 1972-1 Cum. Bull. 735, sets forth the conditions which must be satisfied before the Internal Revenue Service "will consider issuing advance rulings concerning classification of organizations as partnerships . . . where they are formed as limited partnerships and a corporation is the sole general partner." The basic conditions are: (1) the limited partners will not own more than 20 percent of the stock of the corporate general partner and (2) the net worth of the corporate general partner, based on fair market value, must be a minimum of 15 percent of the total contributions or $250,000, whichever is less (if total contributions exceed $2,500,000, the net worth must be at least 10 percent of such contributions).

The syndicator must be aware of and plan to avoid the adverse tax consequences that may arise when the sole general partner in a limited partnership is a corporation. *See* Phillip G. Larson, 65 T.C. No. 10 (Oct. 21, 1975), *opinion withdrawn*, P-H Tax Ct. Rep. & Mem. Dec. ¶ 65, 10 (1975), *second opinion issued*, CCH Tax Ct. Rep. ¶ 7393 (1976); Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975). The following four characteristics are analyzed to determine whether a syndicate should be taxed as an association or a partnership: (1) continuity of life; (2) centralization of management; (3) limited liability; (4) free transferability of interests. Treas. Reg. §§ 301.7701-2 to-3 (1960). For a discussion of the application of these characteristics see Fitzpatrick, *The Critical Uncertainty of the Tax* formed by the developer solely for the purpose of meeting the minimum net worth required thereunder. I am interested in a substantial net worth, a significant portion of which must be in liquid assets. A net worth of $1,000,000 substantially all of which is represented by nonliquid real estate, is not a meaningful net worth. The problem is that when one is in the position of having access only to an offering circular which indicates a gross net worth figure for the general partner, if any at all, it is difficult to make a judgment on this point. One is entitled, however, to ask for the financial statements of the general partner and form his own opinion. If one has some faith in the syndicator of the project, one may rely on his analysis of the financial statements to provide the security to which one is entitled. In any event, the important thing to remember is that the general partner must have a substantial net worth in relation to the size of the project.

I am also interested in the organization of the general partner. From time to time, investors and their representatives complain to me about the many facets of a project which are controlled by the general partner. Architects, insurance agencies, management companies, and mortgage brokers are frequently controlled by the developer. I do not object to these entities being controlled by the general partner; in fact, I welcome them. In my opinion, it is to the advantage of the investor to have the general partner control as many facets of the deal as is consistent with the type of project. The more aspects of the project controlled by the general partner, the more incentive the general partner will have to make the project a success. If the project is a success for the general partner, it will be a success for the limited partner providing it has been properly and fairly structured. If the general partner has control over other facets of the project, it will enable the developer to demand that the proper priority be given to the project's activities. This might not be the case if the service were being provided by an independent party. For example, the timing in an FHA project is often so critical that the failure to abide by the finest detail of FHA regulations may have the effect of seriously hampering the deal, if not killing it altogether.[45] If the general partner controls the architect, the mortgage lender, and the management company, he can control and direct the attention of these entities to the timing required for that particular project.

In most cases, when the general partner controls these other entities, he will have available to him an expertise not usually available from independent parties. An insurance agency which is not familiar with the insurance coverage of subsidized projects will not be able to provide the same service to such projects as if it were its tenth such endeavor. Obviously, the same is true of an architect who has previously constructed

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Status of Public Real Estate Syndicates, 48 St. B. Cal. J. 238 (1973); Halperin & Tucker, *Low Income Housing (FHA 236) Programs: One of Few Tax Shelter Opportunities Left*, 36 J. Tax. 2 (1972).

[45] *See generally* Housing and Urban Development Act of 1968, 12 U.S.C. §§ 1715z (1970); W. Beaton, Real Estate Finance 103-08 (1975); R. Ratcliff, Real Estate Analysis 160-63 (1961); Halperin & Tucker, *Low Income Housing (FHA 236) Programs: One of Few Tax Shelter Opportunities Left*, 36 J. Tax. 2 (1972).

plans for the FHA and knows the FHA requirements. In my experience with both kinds of persons in FHA processing, I can assure one that it is to the investor's advantage to have expert help in these areas. If these areas are controlled by the general partner, the expertise will usually be there.

One other fact regarding this point of control is that the more money the general partner can make on a project, the better it is for the investors. The profit generated by the developer by supplying these other services to the project is not money that is being generated from the investor. It is not a profit which results in a higher price to the investor. The more money the developer makes, the stronger he will be financially. The stronger the general partner, the better off the investor. It is not important to "look down the throat" of a developer; it *is* important to determine if the investor is paying a fair price for his interest in the project.

In every case, the general partner must guarantee completion of the project in accordance with the plans and specifications and to the satisfaction of the lender. This guarantee must be absolute, unconditional, unlimited in amount, and backed by a substantial net worth. A 100 percent payment and performance bond is not, in my opinion, a substitute for a strong net worth. Of course, for additional security, I will insist upon the bond or letter of credit, but usually these will have already been required by the lender.

B. *Operating Deficit Provisions*

The general partner must be obligated to guarantee against operating deficits.[46] This may take the form of a guarantee against default for a certain period of time following the permanent loan closing.[47] Under such an arrangement, the general partner may be obligated to fund all operating deficits for three or four years following permanent loan closing. This is obviously the best kind of guarantee. Alternatively, the general partner may agree to loan the partnership a sum certain for a fixed period of years, *e.g.*, an undertaking to loan the partnership up to $300,000 to fund operating deficits during the first three years following permanent loan closing. One must determine by reference to the operating expenses[48] set forth in the offering circular whether the undertaking of the general partner is sufficient for this purpose. An undertaking to loan up to $100,000 to a partnership for a period of three

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[46] An operating deficit occurs when the operating expenses, including debt service for this purpose, exceed current income. As used in this section of the article, an operating deficit is equivalent to a negative cash flow, *i.e.*, cash disbursements exceed cash receipts.

[47] The permanent, long-term mortgage, not the loans used for financing during construction.

[48] *E.g.*, Schedule A, Column (6) less Column (2) plus principal payments. Depreciation is deducted from total expenses because it is a noncash expense. Principal payments must be added back because they are nondeductible cash outlays. These adjustments yield the total cash outlay required for each year. One must also take into account a section 236 subsidy which will be payable to the mortgagor and therefore reduce the debt service.

years following permanent loan closing is probably not adequate if the operating expenses and debt service for the project will aggregate $500,000 per annum (*after* taking into account the federal subsidy). Such an undertaking by the general partner may not be adequate to cover operating expenses for more than three or four months of the rent-up period.

C. *Conditions of Payments*

In tax shelter investments, the investor usually pays his contribution to the limited partnership over a three, four, or five year period.[49] Of course, every installment payment falling due after the "final endorsement" date should be conditioned on the occurrence of that event. Moreover, every installment payment should be conditioned on other obvious but often overlooked factors, *e.g.*, no material default by the general partner under any agreement or other document such as the partnership agreement, note, mortgage, or FHA Regulatory Agreement, and no material breach of representations and warranties by the general partner under the partnership and other agreements.

In addition, it is customary to condition the last installment or two on the occupancy or break-even point of the project.[50] In this regard, it is important to note what kind of project it is. For example, an apartment project for the elderly normally will not have a rent-up problem so a condition on occupancy for that type of project is not meaningful. In this situation, it may be necessary to impose a break-even condition for the last payment or two, requiring the property to have "broken even" for the six month period preceding the due date of the installment (assuming all operating expenses have been computed on an annual basis).

It is not necessary, however, to secure a condition on the payment of an installment if the general partner is exceptionally strong and has made an absolute undertaking against default for a reasonable period following permanent loan closing or has combined several such undertakings to protect the limited partner. In any event, a condition on payment by the investor is not a substitute for a guarantee of completion or an agreement to make operating deficit loans. These assurances should be present in almost every project. An escrow of part of the installment payments received from the investor against the general partner's obligations may be appropriate in certain cases.

D. *Location of Property*

The location of the property is very important,[51] but because one is only in the position of reviewing an offering circular presented by a

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[49] *E.g.*, Schedule B, Column (7).

[50] "Break-even" in this section of the article refers to a zero cash flow position. Thus, if cash receipts (rental revenues) equal cash disbursements (operating expenses including payments on principal and interest on long-term debt), then the project has broken even. Stated another way, the project does not have an operating deficit.

[51] Location is important in the sense that real estate is not a liquid asset and there may not be a ready market when the seller is prepared to sell it. The location may have a great

client, one is usually not able to make an informed judgment regarding viability of the location. If familiar with the city, one may make some very gross judgments such as whether the project is located in a declining area, what kind of competitive properties are nearby, whether there is adequate shopping, churches, schools, and so forth. Some of this information will be in most offering circulars.

E. *Additional Protection for Investors*

There are additional safeguards that will be helpful to investors and of which one should be aware. There should be a provision that if there is a significant reduction in the amount of the permanent mortgage placed on the property at completion, the purchase price to the investor will be proportionately reduced. If, for example, the mortgage amount is supposed to be $3,500,000 and the permanent mortgage is in fact only $3,200,000, the leverage[52] for the investor (and the resultant tax loss) is not as great. Accordingly, the purchase price should be reduced by whatever percentage decrease the original mortgage amount experienced.[53] But I usually do not request a reduction in price unless the reduction in the mortgage exceeds three to five percent of the original mortgage amount. In other words, a de minimis change will not materially affect the numbers originally projected for the investment and should not be a cause of concern to the investor.

Since in most instances the investor is making his purchase prior to having the permanent mortgage placed on the property, the investor should have an option to cause the general partner to repurchase his interest if the permanent mortgage has not been placed on the property by a certain date. I usually seek to have this option made available to the investor when the permanent mortgage is not placed on the property within one year after the expected date. It is necessary to give the developer some leeway because he cannot control every event which occurs during the construction period. If, however, the permanent mortgage is not placed on the property within some reasonable time after it was supposed to have been, there may be a significant problem in ever placing the mortgage on the property. An option to sell back to the developer protects the investor in this situation.

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bearing on the marketability of the property. The property is also subject to geographic obsolescence which relates to the condition of the neighborhood. *See* S. Freshman, Principles of Real Estate Syndication 55 (1971); R. Ratcliff, Real Estate Analysis 62 (1961).

[52] The use of debt provides two benefits, "the first being an economic benefit and the second being a tax benefit." Joint Comm. on Int. Rev. Tax., 94th Cong., 1st Sess., Overview of Tax Shelters 3 (Comm. Print 1975). The economic benefit arises from the fact that when debt is used in place of equity, the investor has available for alternative use funds that would otherwise have been needed for use by the limited partnership. The tax benefit is based on the principle that debt is treated as equity for tax purposes, *i.e.*, an investor will receive the benefit of depreciation and other deductions over and above his actual investment. Crane v. Commissioner, 331 U.S. 1 (1947). The rate of return on investment varies with the amount of debt or leverage used.

[53] In Schedule B, if the original mortgage ($4,311,100) were reduced by $517,000, the original total investment amount of $776,380 should be reduced by 18 percent of $517,000

F. *Price Paid by Investor*[54]

A good, subsidized project should usually cost the investor between 16 and 18 percent of the mortgage amount. For example, if the permanent mortgage is originally projected at $3,000,000, the price to be paid by all investors (the limited partners) should be $480,000 to $540,000. I believe this price will probably increase to 19 or 20 percent of the mortgage amount in the near future because good, subsidized projects are becoming very scarce indeed.[55]

There are many factors important enough to affect the price. An exceptionally strong general partner is worth a premium of one or two percent of the mortgage amount. Conversely, a weak general partner is worth nothing. As I stated earlier, I consider this factor to be the most important of all.

It is also important to know whether the project is designed for family housing or housing for the elderly. If the project is for the elderly, it will usually be disclosed in the offering circular. An elderly project, in my opinion, is usually worth one or two percent more than a family project. The large group of available tenants assures easy rent-up, lower overall maintenance costs, and general stability of the project. Consequently, the risk of foreclosure is usually significantly less in an elderly project and the tax benefits are more assured over the long run.

The longer the period over which the purchase price is to be paid in, the better for the investors and consequently, the higher the price. An investment payable over four annual installments is usually worth at least one percent more than a deal payable over three years. Because the objective of the investor is to secure tax benefits, longer installment payments will usually increase the amount of leverage, that is, tax loss per dollar in each year of investment.[56]

A deal which allocates 99 percent of the tax losses and cash flow to the limited partners is worth more than a deal that provides 90 percent of such losses. I have noticed that people tend to overlook this point and accept as normal whatever allocations are made in the partnership agreement. Prices of similar deals should be compared on the basis of an allocation of the same percentage of taxable profits, losses, and cash

($93,060); thus each of the 22 limited partnership units should be reduced $4,230 to $31,060. If the purchase price is not reduced, the actual investment represents a greater proportion of the total capital and debt; the price is consequently higher, *e.g.*, 20.5 percent of the mortgage ($776,380 divided by $3,784,000) as compared to 18 percent ($776,380 divided by $4,311,100). In other words, the leverage is decreased. This in turn causes a decrease in the rate of return because less deductions are available to apply against the same actual investment. Thus, the return on investment of 28.12 percent noted on Schedule C would decrease significantly.

[54] The price paid by the investor is one of the variables that determines his rate of return. In Schedule B, assuming all the other variables are constant, as the purchase price of one unit of $35,290 increases, the return on investment of 28.12 percent per Schedule C decreases and vice versa. Thus, the return on investment varies inversely with the purchase price.

[55] *See generally* S. FRESHMAN, *supra* note 51, at 26-27.

[56] When viewed from the perspective of the individual year, rather than the total twenty-year period in Schedule B, leverage (in this sense) in 1975 through 1981 is increased because the proportion of actual investment to the total write-off is decreased on a per year basis.

flow. In fact, if one does the arithmetic for some offering circulars, one may be surprised at the actual price of some deals. If the limited partners are allocated only 80 percent of the taxable losses, for example, one should consider that they are purchasing only 80 percent of the mortgage; accordingly, the price should be measured based on 80 percent of the mortgage and not on the entire amount of the mortgage.

The stronger the guarantees made by the general partners, the higher the price. A guarantee against default of the mortgage for a period of five years following the permanent loan closing and, perhaps, subordination of the management fee (assuming the general partners control the management company) to the cash flow set forth in the projections, is worth a premium to the limited partners.[57] Without appropriate guarantees, however, the deal may not be worthwhile at any price. This is a function of risk and one must weigh many factors in determining whether a lower price is worth the risks involved because of the lack of guarantees by the general partner.

One final comment about the price: In a subsidized project, and probably in every deal, there is a price at which the deal will be uneconomical whether considered from a tax benefit or from an economic gain point of view. Even if a deal were to be guaranteed by a large bank against default for 20 years following completion of the project, the deal may be uneconomical if the price is 23 or 24 percent of the mortgage in the case of a straight subsidized housing project (a non-rehabilitation project). In my opinion, as an absolute maximum, one should never pay more than 21 or 22 percent of the mortgage to participate in a subsidized project.

G. *Some Absolutes in Tax Shelter Projects*

First, the limited partners in the aggregate should receive 90 to 99 percent of the total tax losses available over the first 20 years of the project.[58] I do not want to address myself at this point to the tax questions which may or may not be present in the "flip-flop" situation whereby the losses allocated to the limited partners are reduced to a lesser percentage at some later point in time. Even if the limited partners are allocated only 70 or 80 percent of the tax losses in a subsidized project, these losses should persist for at least 20 years. As I stated previously, in a subsidized project these losses will continue (although at a decreasing rate) for a period of 18 to 20 years after the first year of investment; thus, it is imperative that the tax benefits be made available to the limited partners for that entire period of time. If the general partner insists on a substantial part of the tax losses after the first ten years in a subsidized project, I would not let an investor participate in that deal.

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[57] The purpose of the guarantee is *not* to assure the investor return of his investment at or about that time. Rather, the guarantee is to provide comfort to the investor that operating deficits of the project, which are most likely to occur in the early years of the project, will be totally (or substantially) funded by the general partner.

[58] *E.g.*, Schedule A, wherein each of 22 limited partners receives 4.5 percent of the losses; in total they receive 99 percent of the losses.

Upon refinancing or sale of the project, the limited partners should get back their cash investment[59] prior to the general partner. This assumes, of course, that there are cash proceeds received on such sale or refinancing in excess of the mortgage balance.[60] It is appropriate, however, for the limited partners to have this priority reduced by any cash distribution received by them to the date of such refinancing or sale.[61] Typically, any cash proceeds received in excess of the priority to the limited partners are divided between the general partner and the limited partners on a more or less equal basis.

Disclosed somewhere in the offering circular of all subsidized tax shelter projects should be the estimated amount of tax the limited partners will have to pay upon sale of the project, assuming a price of one dollar above the mortgage balance with a disposition 20 to 22 years after the project has commenced. One should be suspicious of subsidized projects, in particular, which use a sale price in excess of one dollar[62] because such an assumption inflates the rate of return.

H. *Tax Considerations*

Recently, the government has successfully challenged the deductibility of large guaranteed payments,[63] "management" fees, and similar costs.[64] I believe there may be some justification in allocating part of the syndication proceeds to a rent-up fee or management payment to the general partners; I do not believe, however, such allocation should exceed 15 or 20 percent of the equity proceeds from the limited partners. If one reviews a deal syndicated today which has a guaranteed payment of 50 percent or more of the total equity proceeds, one would obviously advise the client not to invest in it. There is no wisdom in buying what I consider to be a certain lawsuit that will surely end up a loser.[65] Moreover, one should look carefully at the explanation behind any guaranteed payment or rent-up fee to satisfy himself that the terms of the services to be performed by the general partner qualify as current deductions.[66]

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[59] *I.e.*, original equity invested minus cash disbursements made prior to the sale or refinancing.

[60] In discussing subsidized projects, one source suggests that "operating costs in these projects almost always exceed those projected at the outset, with the result that investors have realized little or no current cash flow and no economic recovery on a disposition of the project. . . ." Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 508 (1973).

[61] Be sure, however, that this priority includes, in addition to the original investment, all cumulative unpaid cash distributions originally projected to be made to the limited partners.

[62] Even if only one dollar in excess of the mortgage balance is realized upon sale of the project, there will be capital gains payable to the extent that the mortgage balance exceeds the limited partner's basis in the project. *See* Rev. Rul. 66-94, 1966-1 CUM. BULL. 166.

[63] INT. REV. CODE OF 1954, § 707(c).

[64] *See, e.g.*, Edward T. Pratt, 64 T.C. No. 17 (May 8, 1975); Jackson E. Cagle, Jr., 63 T.C. 86 (1974). *See also* Hewitt & Pennell (eds.), *Inconsistencies Between Treatment of Interest and Guaranteed Payments Explored*, 44 J. OF TAX. 95 (1976).

[65] *See* Edward T. Pratt, 64 T.C. No. 17 (May 8, 1975); Jackson E. Cagle, Jr., 63 T.C. 86 (1974).

[66] *See* Weidner, *supra* note 2, at 928.

I always review carefully the depreciation schedule set forth in the financial projections to determine the aggressiveness (if any) of the persons preparing the projections. In my opinion, high-rise building shells, if depreciated by the component method[67] of depreciation, should never have a life of less than 40 years and, in the case of frame garden apartment projects, the structural shell life should never be less than 33 1/3 years. Overall composite rates, if component lives are used, should not be less than 80 percent of shell lives although you will likely get an argument from the Internal Revenue Service if the overall composite rate is anything less than the life designated in Revenue Procedure 62-21[68] or under ADR.[69]

I also review the projections for nondeductible items, such as syndication fees[70] and FNMA or GMNA fees in excess of one percent.[71] Payments to general partners for making guarantees against default, acquisition costs, and construction supervision fees are also not currently deductible although they may very properly constitute part of the depreciable base. I would add that although deduction of any of the above makes me suspicious of the projections, I may not necessarily reject the deal unless the total amount of such items is so significant that it destroys my confidence in the overall projections contained in the offering circular.

IV. Evaluating the Deal

A. *Pay-Back Period*

The pay-back period is the period of time over which an investor will recover his investment. Some offering circulars indicate the pay-back period by reference to each individual annual installment the investor is making, whereas others indicate the entire period over which the last dollar of the investor's payments will be recovered based on the projections. In any event, in a subsidized project, the investor should generally recover his investment no later than the end of the fifth year. Consequently, a deal which recovers the entire investment at the end of the fourth year is a particularly good deal whereas one that recovers the investment at the end of the sixth year may be a mediocre deal. Such a

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[67] Component depreciation is a method of depreciation whereby the building's components (*e.g.*, carpeting, furnace, wiring) are depreciated separately from the building shell. Since these items usually have shorter useful lives than the shell, the use of this method allows faster overall depreciation than if the building is merely depreciated as a whole. *See* G. Robinson, Federal Income Taxation of Real Estate § 15.01[1] (rev. ed. 1974).

[68] 1962-2 Cum. Bull. 418.

[69] Rev. Proc. 72-10, 1972-1 Cum. Bull. 721.

[70] *See, e.g.*, Rev. Rul. 75-214, 1975 Int. Rev. Bull. No. 23, at 9, which states that a limited partnership's payments to one of its general partners for services rendered in organizing the partnership constitute capital expenditures under Internal Revenue Code section 263 and thus are not deductible under section 162.

[71] According to Rev. Rul. 74-395, 1974-2 Cum. Bull. 45, the one percent portion of this fee is deductible as interest under Internal Revenue Code section 163(a) and, therefore, subject to Rev. Rul. 68-643, 1968-2 Cum. Bull. 76. The author takes vigorous exception to this ruling since it involves a conclusion of fact that such fee is interest when, in fact, it is not.

deal, however, may have something else in its favor which may warrant recommending it favorably to the investor. Another point regarding the payback period is that if the period for recovery of the total investment is two or three years, I would be suspicious of the projections and examine it even more closely. Such returns are usually too good to be true.

On Schedule B, note that in the column headed "Cumulative Cash Benefit," the sum of $35,290 (the total purchase price for one limited partnership unit) is reached somewhere in 1979, *i.e.*, between the fourth and fifth years. This is somewhat misleading. Simple interpolation of the cumulative cash benefit at the end of years 1978 and 1979 would indicate the recovery of $35,290 is accomplished no later than October 1979, and probably closer to June or July. This is, at the maximum, four years from the date of the initial investment, October 1975. Thus, one must consider the actual date the first installment is required to be paid when determining the pay-back period.[72] One should also consider how much cash flow contributes to the recovery of the investment. In this Schedule, approximately $4,000 of cash flow is required to reach the $38,645 of total cash benefits at the end of 1979. Even if the cash flow were not generated, the pay-back period would not likely exceed four years.

B. *Return on Investment*

The Return on Investment Schedule (Schedule C) usually discloses the after-tax rate of return on the investment. This computation distills all the important numbers applicable to the project into an annual rate which takes into account the timing of the installment payments by the investor as well as the timing of the tax deductions. This after-tax rate of return on investment is a true measurement of the time-value of money and is comparable with other after-tax rates of return, such as the return on a municipal bond or the return on a corporate bond after provision for personal taxes on the interest.

In my judgment, a subsidized project which discloses an after-tax rate of return of less than 15 percent is probably overpriced and is not worth the investment. Generally, I like to see an after-tax rate of return on a subsidized project of 19 or 20 percent. I think that 22 or 23 percent, or greater, is a very good deal. There are, however, some circumstances which warrant investing in a subsidized project with a lower than 19 or 20 percent rate of return. For example, it is possible that the projections are very conservatively prepared or that the low rate of return may carry with it substantial guarantees by strong general partners. Such low risk/low rate of return projects may be appealing when your particular investor is exceptionally conservative.

The Return on Investment Schedule also discloses the recovery of

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[72] Thus, the investment in this case is not actually recovered over a five-year period as would seem to appear from the Schedule, since the interval between the first investment in October 1975, and recovery in 1979, is only 48, not 60 months. This results only because the first year investment is made in October 1975, rather than January or February 1975.

the investment and the investment balance. These schedules often contain a sinking fund which begins somewhere around the eleventh year and continues until the end of the schedule, usually about the twentieth year. The purpose of this is to demonstrate that the tax benefits from years 11 onward (assuming that such benefits are reinvested at a tax-free income rate of four percent) must be set aside to pay the capital gains tax on disposition of the property at the end of the twentieth year of the project — even if the project is sold at a price one dollar above the then existing mortgage balance. This schedule is very complicated and I would only mention here that its purpose in your hands should be primarily to compare one deal with another.

C. *Out-of-Pocket Exposure (Liquidity Factor)*

Usually there will be a schedule in the projections which discloses the cumulative effect of the combined benefits of tax savings[73] and cash flow[74] versus the amount of the investment[75] on an annual basis. From this one will be able to determine the maximum out-of-pocket exposure[76] to the investor. For instance, if the total investment required to be paid over a five year period by an investor is $50,000, and on a cumulative basis the investor is never out-of-pocket more than $5,000, then the out-of-pocket exposure is only ten percent of the total investment amount — a very safe exposure.[77]

In conjunction with the "out-of-pocket exposure," one must consider the liquidity factor. In the example above, I considered the investor's maximum liqudity factor to be $5,000 in the particular project (and that is usually only for a short period of time). Nevertheless, investors will complain that they do not want to tie up $30,000 or $40,000 to purchase a limited partnership unit in a particular project, because they do not want to reduce their portfolio liquidity by such an amount. My position is that since the investment is made substantially from tax savings, liquidity is not an important consideration in a properly structured tax shelter project. It is not as if the investor were writing a check or cashing a certificate of deposit to make the investment. Although this may be true for a short period of time, the payment of a particular installment by an investor will usually be recouped quickly from tax savings due to lower estimated tax payments.[78] Liquidity should, therefore, be of little or no consequence in a well structured deal.

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[73] *See* Schedule B, Column (3) and accompanying explanation.

[74] *See* Schedule B, Column (4) and accompanying explanation.

[75] *See* Schedule B, Column (7) and accompanying explanation.

[76] *See* Schedule B, Column (8) and accompanying explanation.

[77] Schedule B, Column (8) shows that for that deal the investor has an out-of-pocket investment in only one year, 1977. In all other years the total benefits exceed the total investment.

[78] Quarterly estimated tax payments are required for certain individuals by sections 6015 and 6153 of the Internal Revenue Code.

D. *Timing of the Deal*

A project which commences construction in the early part of the year usually affords more tax shelter in the first year than a deal which starts in the latter part of the year. A deal which has a tax loss per limited partnership unit of $3,000 in year one, $14,000 in year two, and $12,000 in year three represents a deal that should be syndicated in the second year and not in the first year. Unless the deal is exceptional, there is no point in putting the investor into the deal unless the first year tax shelter is significant in relation to the second year shelter. To me, this means that the first year tax shelter should be no less than 40 percent of the amount of tax shelter available in the second year. I would also point out that in a deal starting very late in the year, one should carefully examine the tax deductions for the first year to make sure that they are legitimate and not "padded" with questionable deductions in order to make it syndicable in the first year simply because the project has had an "initial loan closing" with HUD (FHA).

E. *Front-End Load*

I believe one does the investor a disservice if one is concerned about the division of the syndication proceeds between the developer and the syndicator. Whether the syndicator gets ten or twenty percent of the syndication proceeds is not terribly relevant — what is important is the total price paid by the investor, the recovery period of the investment, and the after-tax rate of return. There may be many reasons which justify the syndicator receiving more than ten percent of the syndication proceeds in a particular deal. For example, the syndicator could have helped obtain the mortgage financing or could have helped in the initial structuring of the deal before the time he would ordinarily have become involved. On the other hand, there is no justification for entering into a deal which does not yield a suitable rate of return.

F. *Payback of Tax Benefits Upon Disposition*

I have pointed out that the use of money is the *raison d'etre* for investing in a tax shelter. If the period during which money is made available for reinvestment by an investor is significant, it is unimportant that a substantial part of the tax benefits generated by the deal have to be repaid[79] to the Treasury upon disposition of that project. First, the investor will probably have converted a significant amount of ordinary income into capital gain.[80] Secondly, the investor should have realized a large return on reinvestment of the tax savings. Ad-

[79] *See* Schedule C-50 percent, line 15 and the accompanying explanation.

[80] Depreciation deductions will reduce ordinary income but upon disposition of the property (assuming the property has been held long enough to avoid the recapture provisions of the Internal Revenue Code) the proceeds are taxed not as ordinary income, but as capital gain under Internal Revenue Code section 1231. In any event, the straight line depreciation and construction period expenses are taxed as capital gain regardless of when the disposition occurs.

ditionally, when the tax benefits are paid back to the Treasury after 20 years or so, they are probably paid back with dollars that are worth, at an inflation rate of only three percent, less than half of the tax savings realized from the project. Thus, there is a very real "in pocket" savings to the investor resulting from the use of money provided by a long-term tax shelter investment.

V. Conclusion

I hope that my remarks will be helpful in evaluating tax shelter investments proposed by one's client. I know that, theoretically, professionals are only asked to render tax and accounting advice to their clients. It is an inescapable fact, however, that the client relies on the judgment and experience of accountants and attorneys when making an investment decision. It is also a fact that few accountants and few attorneys have the depth of expertise to analyze an offering circular, which is very long and very complex. Although I could have expanded my comments on many of the points I have covered and discussed some others which may be helpful in the less traditional deal, I believe that the basic points which I have treated are the most significant factors that must be considered when evaluating the most common kind of deal one is likely to see. At the very least, if one is going to advise a client to accept or reject an investment in a proposed tax shelter, I hope that I have provided the basis with which to make a well-informed judgment.

SCHEDULES

SCHEDULE A
PROJECTED TAXABLE INCOME

(1) Year	(2) Depreciation Expense	(3) Interest Expense	(4) Fees/ Points	(5) Construction Expense	(6) Total Deductions	(7) Net Rental Income Before Debt Service and Depreciation	(8) Taxable Profit/ Loss	(9) All Other Partners 95.5 percent	(10) One Limited Partner 4.5 percent
1975	58166	0	209794	126692	394651	0	-394651	-376892	-17759
1976	347923	282167	76636	100000	806725	400698	-406027	-387756	-18271
1977	321287	420687	50000	0	791974	482452	-309522	-295594	-13928
1978	291347	419618	0	0	710965	482452	-228513	-218230	-10283
1979	261407	418441	0	0	679847	482452	-197395	-188512	-8883
1980	231466	417147	0	0	648613	482452	-166161	-158684	-7477
1981	204893	415726	0	0	620618	482452	-138166	-131949	-6217
1982	195152	414161	0	0	609312	482452	-126860	-121151	-5709
1983	197969	412445	0	0	610413	482452	-127961	-122203	-5758
1984	216171	410557	0	0	626727	482452	-144275	-137783	-6492
1985	213847	408481	0	0	622328	482452	-139876	-133582	-6294
1986	192392	406199	0	0	598590	482452	-116138	-110912	-5226
1987	174233	403691	0	0	577923	482452	-95471	-91175	-4296
1988	159370	400933	0	0	560303	482452	-77851	-74348	-3503
1989	144508	397903	0	0	542410	482452	-59958	-57260	-2698
1990	129645	394571	0	0	524215	482452	-41763	-39884	-1879
1991	114923	390909	0	0	505831	482452	-23379	-22327	-1052
1992	123194	386882	0	0	510075	482452	-27623	-26380	-1243
1993	120319	382457	0	0	502775	482452	-20323	-19408	-915
1994	106298	377591	0	0	483888	482452	-1436	-1371	-65

SCHEDULE B-50 PERCENT
PROJECTED CASH FLOW
FOR LIMITED PARTNER
50 PERCENT TAX BRACKET

(1) Year	(2) Taxable Profit/ Loss	(3) Tax Savings	(4) Cash Flow	(5) Annual Cash Benefit	(6) Cumulative Cash Benefit	(7) Investment	(8) Cumulative Net Savings/ -Investment
1975	-17759	8880	0	8880	8880	8650	230
1976	-18271	9136	0	9136	18015	9230	135
1977	-13928	6964	1361	8325	26340	9000	-540
1978	-10283	5142	1361	6503	32843	1682	4281
1979	-8883	4441	1361	5802	38645	1682	8401
1980	-7477	3739	1361	5100	43745	1682	11819
1981	-6217	3109	1361	4470	48215	1682	14607
1982	-5709	2854	1361	4215	52430	1682	17140
1983	-5758	2879	1361	4240	56670	0	21380
1984	-6492	3246	1361	4607	61277	0	25987
1985	-6294	3147	1361	4508	65786	0	30496
1986	-5226	2613	1361	3974	69760	0	34470
1987	-4296	2148	1361	3509	73269	0	37979
1988	-3503	1752	1361	3113	76381	0	41091
1989	-2698	1349	1361	2710	79091	0	43801
1990	-1879	940	1361	2301	81392	0	46102
1991	-1052	526	1361	1887	83279	0	47989
1992	-1243	622	1361	1983	85262	0	49972
1993	-915	457	1361	1818	87080	0	51790
1994	-65	32	1361	1393	88473	0	53183

SCHEDULE B-60 PERCENT
PROJECTED CASH FLOW
FOR LIMITED PARTNER
60 PERCENT TAX BRACKET

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Year	*Taxable Profit/ Loss*	*Tax Savings*	*Cash Flow*	*Annual Cash Benefit*	*Cumulative Cash Benefit*	*Investment*	*Cumulative Net Savings/ -Investment*
1975	-17759	10656	0	10656	10656	8650	2006
1976	-18271	10963	0	10963	21618	9230	3738
1977	-13928	8357	1361	9718	31336	9000	4456
1978	-10283	6170	1361	7531	38867	1682	10305
1979	-8883	5330	1361	6691	45558	1682	15314
1980	-7477	4486	1361	5847	51405	1682	19479
1981	-6217	3730	1361	5091	56497	1682	22889
1982	-5709	3425	1361	4786	61283	1682	25993
1983	-5758	3455	1361	4816	66099	0	30809
1984	-6492	3895	1361	5256	71355	0	36065
1985	-6294	3777	1361	5138	76493	0	41203
1986	-5226	3136	1361	4497	80990	0	45700
1987	-4296	2578	1361	3939	84928	0	49638
1988	-3503	2102	1361	3463	88391	0	53101
1989	-2698	1619	1361	2980	91371	0	56081
1990	-1879	1128	1361	2489	93860	0	58570
1991	-1052	631	1361	1992	95852	0	60562
1992	-1243	746	1361	2107	97959	0	62669
1993	-915	549	1361	1910	99868	0	64578
1994	-65	39	1361	1400	101268	0	65978

Schedule C-50 percent
Return on Investment Schedule
For Rate of Return of 28.12 percent
Limited Partner in 50 Percent Tax Bracket

(1) Year	(2) Annual Cash Benefit	(3) Return on Investment @ 28.12 percent	(4) Return of Investment	(5) Capital Contribution	(6) Investment Balance	(7) Earnings on Surplus
1975	8880	2432	6447	8650	2203	
1976	9136	3215	5921	9230	5512	
1977	8325	4081	4245	9000	10267	
1978	6503	3360	3143	1682	8807	
1979	5802	2949	2853	1682	7636	
1980	5100	2620	2480	1682	6838	
1981	4470	2396	2074	1682	6446	
1982	4215	2285	1930	1682	6198	
1983	4240	1743	2497	0	3701	
1984	4607	1041	3567	0	134	
1985	4508	38	134	0	(4512)	175
1986	3974	0	0	0	(8829)	343
1987	3509	0	0	0	(12836)	498
1988	3113	0	0	0	(16593)	644
1989	2710	0	0	0	(20083)	780
1990	2301	0	0	0	(23288)	904
1991	1887	0	0	0	(26192)	1017
1992	1983	0	0	0	(29313)	1138
1993	1818	0	0	0	(32389)	1258
1994	1393	0	0	0	(35147)	1365
	88473	26159	35290			

(8) *Tax Losses*	127950
(9) *Cash Distributions*	24498
(10) *Proceeds of Sale*	1
	152449
(11) *Less: Investment*	35290
(12) *Capital Gain*	117159
(13) *Capital Gains Tax* (.30)	35148
(14) *Less: Proceeds of Sale*	1
(15) *Cash Needed to Pay Capital Gains Tax*	35147

Notes:

The annual rate of return on investment was calculated assuming that an investor limited partner would sell his partnership interest at the end of year 20 for one dollar. For 50 percent and 60 percent tax bracket taxpayers, some of the cash generated in year 11 and all of the cash generated in years 12 to 20, will be set aside to pay the capital gains tax which will result from the sale. In calculating the rate of return it was assumed income would be earned on any cash set aside for this purpose at an after-tax rate of four percent a year compounded semi-annually.

SCHEDULE D-60 PERCENT
RETURN ON INVESTMENT SCHEDULE
FOR RATE OF RETURN OF 41.37 PERCENT
LIMITED PARTNER IN 60 PERCENT TAX BRACKET

(1) Year	(2) Annual Cash Benefit	(3) Return on Investment @ 41.37 percent	(4) Return of Investment	(5) Capital Contribution	(6) Investment Balance	(7) Earnings on Surplus
1975	10656	3578	7077	8650	1573	
1976	10963	4469	6494	9230	4309	
1977	9718	5505	4213	9000	9096	
1978	7531	4459	3072	1682	7706	
1979	6691	3883	2807	1682	6581	
1980	5847	3418	2429	1682	5833	
1981	5091	3109	1983	1682	5532	
1982	4786	2984	1802	1682	5413	
1983	4816	2239	2577	0	2836	
1984	5256	1173	2836	0	(1298)	50
1985	5138	0	0	0	(6696)	260
1986	4497	0	0	0	(11644)	452
1987	3939	0	0	0	(16213)	630
1988	3463	0	0	0	(20471)	795
1989	2980	0	0	0	(24398)	947
1990	2489	0	0	0	(27973)	1086
1991	1992	0	0	0	(31176)	1211
1992	2107	0	0	0	(34627)	1345
1993	1910	0	0	0	(38013)	1476
1994	1400	0	0	0	(41005)	1592
	101268	34818	35290			

(8) *Tax Losses*	127950
(9) *Cash Distributions*	24498
(10) *Proceeds of Sale*	1
	152449
(11) *Less: Investment*	35290
(12) *Capital Gain*	117159
(13) *Capital Gains Tax* (.35)	41006
(14) *Less: Proceeds of Sale*	1
(15) *Cash Needed to Pay Capital Gains Tax*	41005

Notes:

The annual rate of investment was calculated assuming that an investor limited partner would sell his partnership interest at the end of year 20 for one dollar. For 50 percent and 60 percent tax bracket taxpayers, some of the cash generated in year 10 and all of the cash generated in years 11 to 20, will be set aside to pay the capital gains tax which will result from the sale. In calculating the rate of return it was assumed income would be earned on any cash set aside for this purpose at an after-tax rate of four percent a year compounded semi-annually.